IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1974

No. 73-5265

HENRY A. KOKOSZKA, Bankrupt,

Petitioner,

v.

RICHARD BELFORD, Trustee in Bankruptcy of the Estate of Henry A. Kokoszka, Bankrupt,

Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITIONER'S REPLY BRIEF

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Petitioner files this brief as permitted by Rule 41(5) to discuss new matter and by Rule 40(4) to reply to the Brief of Amicus Curiae for Respondent.

I.

GEHRIG V. SHREVES, DECIDED AFTER THE FILING OF PETITIONER'S BRIEF, DEALS WITH THE SAME ISSUES PRESENTED BY THIS CASE.

Gehrig v. Shreves is reported at 491 F.2d 668 (8th Cir. 1974).

A. The Eighth Circuit Properly Decided That The Income Tax Refund Is Not §70a(5) Property.

After close analysis of *Lines v. Frederick*, 400 U.S. 18 (1970) and *Segal v. Rochelle*, 382 U.S. 375 (1966), the Eighth Circuit concluded that an income tax refund attributable to minimum withholding is not property within the purview of §70a(5) of the Bankruptcy Act.

In so deciding, the Eighth Circuit agreed with the decision of the Ninth Circuit in *In re James*, 470 F. 2d 996 (1972), and rejected the Second Circuit's decision below as to that issue.

The court's analysis in *Gehrig* is remarkably similar to the position presented by petitioner in his main brief. Accordingly, petitioner will call the Court's attention to only two significant aspects of *Gehrig*.

First, the court made clear that in neither *In re Jones* 337 F. Supp. 620 (D. Minn. 1971) nor *In re Wetterhof*, 453 F. 2d 544 (8th Cir.) had it ruled on the issue of the income tax refund as property. Both cases were cited in the courts below to support their position (A. 22, 29). In view of the decision in *Gehrig*, neither case can now be cited as contrary to bankrupt's position here. *In re Kingswood*, also cited in the District Court and by the Amicus in this Court, has been reversed. 470 F.2d 996 (1972).

Second, the court concluded that as a matter of legal analysis and practical reality the tax refund check is a much future wages as the payments protected in *Lines*. "(A) low income wage earner must . . . spend all his funds on hand for personal and family sustenance whenever these funds become available."

B. The Eighth Circuit Incorrectly Concluded That The CCPA Does Not Protect A Bankrupt's Tax Refund Checks.

In *Gehrig v. Shreves*, 491 F.2d 668 (8th Cir. 1974), the court concluded that the portion of an income tax refund which represents optional withholding is, in effect, "savings". Since such a fund is savings, rather than "earnings" within the Consumer Credit Protection Act (CCPA), the court stated that the garnishment restrictions of the CCPA are not applicable.

It should be noted that the Eighth Circuit was referring only to the CCPA's application to optional overwithholding. The case presented in *Kokoszka* does not involve optional overwithholding, so that the "savings" analogy cannot be made.

Even so, the Bankrupt believes the Eighth Circuit was mistaken in stating that earnings when transformed into savings are not protected by the CCPA. The CCPA refers to compensation "paid or payable". 15 U.S.C. §1672(a). In such circumstances, this Court has held that payments retain their exempt quality even after deposit in a bank account. The test is whether the payments are subject to use for maintenance and support, and have not been converted into a permanent investment. *Philpott v. Essex County Welfare Board*, 409 U.S. 413, 416 (1973).

The agency charged with administering the CCPA has also concluded that, whether already paid or still payable, the wages retain their exempt character. (Petitioner's Brief, p. 37-38 and n. 15.)

Finally, nothing in the *Gehrig* record revealed voluntary excess withholding on the part of the bankrupt. Accordingly, the court's conclusion as to the inapplicability of the CCPA is dictum.

II.

THE DISPOSITION OF THIS CASE SHOULD NOT AFFECT THIS COURT'S DISPOSITION OF ANOTHER CASE ON ITS PRESENT DOCKET, *OTTE V. U.S.*

In re Freedomland, Inc., 480 F. 2d 184 (CA 2 1973) was cited by petitioner in support of the proposition that a bankrupt's personal tax refund check retains its original character as wages. (Petitioner's Brief pp.14, 29). This Court decided to reveiw *Freedomland* sub nom *Otte v. U.S.* Docket No. 73-375, 42 L.W. 3415 after the mailing of the Petitioner's Brief.

Two issues presented by *Freedomland* may be pertinent here. First, the *Freedomland* court decided that pre-bankruptcy funds of the bankrupt corporation to be paid by the trustee to the bankrupt's employees constitute wages as defined by the Internal Revenue Code. Thus far all the courts that have considered that point agree that the trustee's payments to the employees are wages. *U.S. v. Fogarty*, 164 F.2d 26, 29-32 (8th Cir. 1947); *U.S. v. Curtis*, 178 F.2d 268 (6th Cir. 1949); *Lines v. State Dept. of Employment*, 242 F.2d 201, 201-203 (9th Cir. 1957); In *Lines v. State Department of Employment, supra*, the Ninth Circuit stated:

> "The mere fact that the sums were actually paid to the employees by the Trustee does not deprive the payments of their primary identification as wages." *Id.* at 203.

The Ninth Circuit's holding in this regard is entirely consistent with their holding that a wage earner bankrupt's tax refund check constitute wages:

> "There does not appear to be any reason of policy why the amount of the refund should be

held to have lost its character as earnings by reason of its somewhat circuitous route to the wage earners hand." *In re Cedor*, 337 F. Supp. 1103, 1107. opinion adopted by the Ninth Circuit *sub nom. Riggs v. James*, 470 F.2d 996 (9th Cir. 1972), *cert den. sub. nom. Walsh v. Cedor*, 411 U.S. 973 (1973).

Other cases at issue in *Freedomland* tend to support Kokoszka's position herein that his tax refund check constitutes wages. In *Social Security Board v. Nierotko*, 327 U.S. 358 (1946) the Court held that a "back pay" award under the National Labor Relations Act should be treated as wages for purposes of eligibility for old age benefits under the Social Security Act. *Id.* at 364-66. In *Shropshire Woodliff & Co. v. Bush*, 204 U.S. 186, the Court held that an assignment of wages did not change the character of the payment to the assignee from wages.

The second issue in *Freedomland* possibly relevant herein in the distribution priority under 11 U.S.C. §104, of money to be paid to the Internal Revenue Service by the trustee of the bankrupt corporation as withholdings of the employee's wages. This court may decide that the proper priority is as costs and expenses of administration, wages, or taxes due and owing. However, the resolution of this issue should not affect the court's disposition of *Kokoszka* since the legal questions and policy issues are quite different.

Thus, it appears that the issues in *Freedomland* and *Kokoszka* are largely unrelated. To the extent the issues are similar, *Freedomland* and its companion cases tend to support Kokoszka's contention that his tax refund check constitutes wages.

III.

WELL ESTABLISHED PRINCIPLES DEMONSTRATE THAT THE BANKRUPT'S INCOME TAX REFUND IS NOT PROPERTY WITHIN THE MEANING OF THE BANKRUPTCY ACT; IT IS FUTURE WAGES UNDER THE HOLDING OF *LINES V. FREDERICK.*

The brief of amicus curiae for respondent presents a novel and highly conceptual approach to the issues herein. There the amicus argues that "property" is to be construed for the benefit of creditors, and the fresh start purpose of the Bankruptcy Act is adequately served by the provisions for the debtor's discharge and allowance of his exemptions. These points can best be understood by a brief re-examination of petitioner's presentation.

Kokoszka argues that the purpose of the Bankruptcy Act to give a debtor his fresh start places a limitation on the meaning of the word "property".

Noting that the Bankruptcy Act does not define the word property, Mr. Justice Harland stated in *Segal v. Rochelle*, 382 U.S. 375, 379:

> Whether an item is classed as "property" by the Fifth Amendment's Just Compensation Clause or for the purposes of a state taxing statute cannot decide hard cases under the Bankruptcy Act, whose own purposes must govern.

In *Lines v. Frederick*, 400 U.S. 18, this court noted that "The most important consideration limiting the breadth of the definition of 'property' lies in the basic purpose of the Bankruptcy Act to give the debtor a [fresh start]." *Id.* at 19. The other prominent purpose of the Bankruptcy Act is to secure property for the bankrupt's creditors. *Segal v. Rochelle, supra.*

In the case herein, Kokoszka contends that application of this analysis to his income tax refund should result in a holding that the refund check is not property because it is as much future wages as the vacation pay in *Lines*. The "elements" of *Lines* are set forth in Petitioner's brief pp. 8-10, and those same elements are present here. Furthermore, Petitioner's brief demonstrates that the refund is a planned on annually recurring event as much a part of a family's basic budget as vacation pay. *In re Cedor*, 337 F. Supp. 1103, 1105; *Gehrig v. Shreves, supra.* Nor has it been created as the result of any "investment", loan, or voluntary act by the bankrupt. But for legally mandated withholding, these wages would have been available when paid and would have been used for Kokoszka's support. Mr. Blackmun made the same point in a dissenting opinion:

> "Were it not for the withholding scheme the amounts would have been paid out to the employees as gross wages". *U.S. v. Randall*, 401 U.S. 513, 518.

It is the Internal Revenue Code and not action by the bankrupt which has turned these wages into "future wages". Furthermore the bankrupt herein is not contending that *Lines* should apply to property interests traceable to wages. The Bankrupt argues that the refund check *is* future wages under the holding of *Lines*.

Thus, although the theory of the amicus brief that the word property should only be construed for the benefit of creditors is novel, the Court has in fact adopted a broader approach of defining the word by reference to the purposes of the Bankruptcy Act. See *Local Loan v. Hunt*, 292 U.S. 234; *Segal v. Rochelle*,

supra; Lines v. Frederick, supra; and *Perez v. Campbell*, 402 U.S. 637. If the Court accepts the amicus' argument that the purpose of the Bankruptcy Act to give a debtor a fresh start does not impose a limitation on the meaning of the word property in the Bankruptcy Act, it would amount to overruling the approach, if not the result, of all these cases. Such an extreme departure is unwise and unwarranted not in the least because it would re-open a vast array of legal problems which are not regarded as settled.

The second aspect of the amicus' theory is that the only property to be retained by the bankrupt is exempt property. (Brief of Amicus pp. 11-20). Aside from the fact that this analysis begs the central question of the scope and meaning of the word property, it is also entirely without support. This Court has never refrained from an analysis of the definition of property because the asset in question was protected by an exemption statute. In *Legg v. St. John*, 296 U.S. 489, 491, a case emphasized by the amicus, this court noted that the monthly disability payments in question were partially exempt as income, but then went on to analyze whether the remainder was "property". Most recently in *Lines v. Frederick, supra,* this Court noted that vacation pay was partially exempt under California law. (*Id.* at 18); but, nevertheless, held that the remainder was not property within the meaning of the Bankruptcy Act.

Apparently, the amicus urges this limited application of the "fresh start" doctrine because he feels that such a limited application "is not to the detriment of [a bankrupt's] creditors". (Brief of Amicus Curiae pp. 22-23) However, at no point in his brief did the amicus for the trustee even attempt to rebut the bankrupt's substantial evidence that a ruling in the bankrupt's

favor will not be to creditor's detriment. (Petitioner's Brief p. 18).

F[illegible] amicus misconstrues the bankrupt's pc[illegible]esting that this Court is being asked to judici[illegible] a new federal exemption. The Bankrupt herein [illegible] only to have this Court engage in its traditional function of interpreting federal statutes: namely, the use of the word property in the Bankruptcy Act. The bankrupt's presentation is that ordinary legal analysis and the practical realities of the situation compel a decision in his favor.

Nor need the Court be deterred by the possibility of the revision of the Bankruptcy Law. As the bankrupt pointed out in his opening brief, and as the amicus seems to acknowledge, the findings of the Commission would support a holding by this Court that the refund check is not property. Similarly in *Snaidach v. Family Finance, supra,* the CCPA was enacted, but not yet effective. The Court in *Snaidach* found the policies of the CCPA supported that decision rather than favoring abstention. The same considerations apply to this case.

IV.

LEGG V. ST. JOHN IS INAPPLICABLE TO THE FACTS OF THIS CASE AND SHOULD BE REGARDED AS OVERRULED.

Legg v. St. John, 296 U.S. 489 is relied on extensively by the amicus for respondents (Brief of Amicus Curiae pp. 24-25, 35). In *Legg* a totally and permanently disabled bankrupt was entitled to receive monthly disability benefits as a supplementary benefit under his life insurance policy. Most of those benefits were not exempt. The Court held that these benefits were property that passed to the trustee.

Initially the *Legg* case is distinguishable from *Kokoszka* in two important respects. First, the Court determined the disability benefits as paid-up insurance. *Id.* at 495. Since it was a voluntary investment, the fund in *Legg* differs markedly from the involuntary nature of the tax refund check which is not in any respect an "investment". Additionally, in *Legg* the Court found that the benefits in question were not earnings; whereas the refund check in question here is nothing else but earnings.

Nevertheless, *Legg* is a harsh and unusual departure from the line of decisions by this Court interpreting the fresh start doctrine. Because Legg was permanently disabled, his ability to be "free from the burden of past debt and free to accumulate new wealth" depended upon receipt of his disability payments. It makes no difference to the bankrupt if his creditors obtain his non-exempt disability benefits through execution or if the bankruptcy trustee obtains it under §70. To Legg bankruptcy provides no protection and no fresh start. There the decision of this Court left Legg utterly trapped in the pauperism which the Bankruptcy Act was designed to relieve.

Legg v. St. John has never been cited or followed by this Court since it was decided. In light of *Lines v. Frederick* and *Perez v. Campbell*, it should properly be regarded as overruled. *Legg* is also inconsistent with the modern approach of this Court as stated in *Goldberg v. Kelly*, 397 U.S. 254 (1970); *California Department of H.R.D. v. Java*, 402 U.S. 121 (1971); *Snaidach v. Family Finance*, 395 U.S. 337 (1969); *James v. Strange*, 407 U.S. 128 (1972); *Philpott v. Essex County Welfare Board*, 409 U.S. 413 (1973); *U.S. v. Kras*, 409 U.S.

435* (1973). In any event, it is a highly unusual departure from a long chain of decisions of this Court and it interprets the Bankruptcy Act in such a harsh, legalistic way so as to deprive it of its central purpose. Thus, because *Legg* is an aberration, because it was wrongly decided, and because it has been overruled by implication, it should not be resurrected now and extended to apply to Kokoszka.

V.

THE EXEMPTION GRANTED BY THE CCPA IS APPLICABLE IN BANKRUPTCY.

In connection with the "property" question, the amicus for respondent argued that exemptions are important to the statutory scheme of bankruptcy. Despite his emphasis on the importance of exemptions to the bankrupt, the amicus for the trustee argues that the CCPA is not applicable even though exemptions "prescribed by the laws of the United States" are recognized by Section 6 of the Bankruptcy Act. The bankrupt's position herein is that the CCPA applies both by the terms of the Bankruptcy Act in §6 and by the terms of the CCPA itself.

The amicus relies principally on the legislative history of the Consumer Credit Protection Act (CCPA) to

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*[C]ongressional concern for the debtor, [is] apparent from the provisions permitting the debtor to file his petition without payment of any fee, with consequent freedom of subsequent earnings and of after-acquired assets (with the rare exception specified in §70(a) of the Act), . . . from the claims of then existing obligations. These provisions . . . enable a bankrupt . . . to protect his future earnings and property, and to have his new start with a minimum of effort and financial obligation. *Id.* at 448-9.

support his argument that the CCPA is not applicable to a bankrupt's income tax refund. His position is that the legislative intent behind the CCPA was to prevent wage earners from being forced into bankruptcy by protecting their wages from excessive garnishment. But the prevention of bankruptcies was not the exclusive motivating force behind the CCPA. There is also the expressed intent to establish uniform bankruptcy laws. This presumes bankruptcy has occurred. [15 U.S.C. §1671(a) (3) and (b)]. Uniformity is effected by the application of the CCPA garnishment restriction to the previously varied state wage exemptions.** In this light, the reference to Chapter XIII orders of the Bankruptcy Court, [15 U.S.C. §1673(b) (2)], clearly presupposes the CCPA's applicability to bankruptcy proceedings.

Congress may not have adverted to the peculiar situation of the income tax refund when it adopted the CCPA. However, the natural reading of the statutory language encompases the refund. "[I]f Congress has made a choice of language which fairly brings a given situation within a statute, it is unimportant that the particular application may not have been contemplated by the legislators." *Barr v. U.S.*, 324 U.S. 83, 90 (1944); *Daniel v. Paul*, 395 U.S. 298, 307 (1969); *NLRB v. Plasterer's Local Union*, 404 U.S. 116, 128-29 (1971).

The definition of earnings includes all forms of compensation for personal services, whether periodic in nature or not. As argued in petitioner's brief, other

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**In at least one prominent bankruptcy jurisdiction, the portion of the refund attributable to earnings within the 30 day period prior to bankruptcy was considered exempt under the wage exemption there applicable. *In Re James*, 470 F.2d 996 (9th Cir. 1972) (Record p. 5).

provisions of the CCPA also support its application to the income tax refund; and so do the interpretations of the administering agency.

Here again, the trustee misstates the bankrupt's position. There is no contention that the CCPA applies to every asset traceable to wages. The refund is directly and specifically part of wages. *E.g., U.S. v. Randall*, 401 U.S. 513, 518 (dissent by Blackmun, J.) For the trustee to take it would have a "harsh and burdensome effect" on the wage earning employee. H. Rep. No. 1040, 2 U.S. Cond Cong. & Adm. News 1966 (1968).

The trustee next argues that his taking of the refund is not the type of garnishment with which Congress was concerned. But again, the statutory definition is not restricted to the traditional concept of garnishment. It expressly includes any legal or equitable procedure. *Hodgson v. Christopher*, 365 F. Supp. 583, 586-87 (D.N.D. 1973); *Philpott v. Essex County Welfare Board*, 409 U.S. 413 (1973); Petitioner's Brief, p. 31-34.

CONCLUSION

For the reasons stated herein, and in Petitioner's Brief, this Court is respectfully requested to reverse the ruling of the Second Circuit Court of Appeals.

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